08-Aug-2023

Cronos Group, Inc. (CRON.CA)

Q2 2023 Earnings Call

CORPORATE PARTICIPANTS

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Vivien Azer
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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Victor, and I'll be your conference operator today. I would like to welcome everyone to Cronos's 2023 Second Quarter Earnings Conference Call. Today's call is being recorded. At this time, I would like to turn the call over to Shayne Laidlaw, Investor Relations. Please go ahead.

Shayne Laidlaw

Head-Investor Relations, Cronos Group, Inc.

Thank you, Victor, and thank you for joining us today to review Cronos's 2023 second quarter financial and business performance. Today I am joined by our chairman, President and CEO, Mike Gorenstein; and our CFO, James Holm. Cronos issued a news release announcing our financial results this morning, which is filed on our EDGAR and SEDAR profile. This information, as well as the prepared remarks will also be posted on our website under Investor Relations.

Before I turn the call over to Mike, let me remind you that we may make forward-looking statements and refer to non-GAAP financial measures during this call. These forward-looking statements are based on management's current expectations and assumptions that are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements.

Factors that could cause actual results to differ materially from expectations are detailed in our earnings materials and our SEC filings that are available on our website, by which any forward-looking statements made during this call are qualified in their entirety. Information about non-GAAP financial measures, including reconciliations to US GAAP can also be found in the earnings materials that are available on our website. Lastly, we will be making statements regarding market share information throughout this conference call. And unless otherwise stated, all market share data is provided by Hifyre. We will now make prepared remarks and then we'll move to a question-and-answer session.

With that, I'll pass it over to Cronos' Chairman, President and CEO, Mike Gorenstein.

Michael Ryan Gorenstein

Chairman, President & Chief Executive Officer, Cronos Group, Inc.

Thank you, Shayne, and good morning, everyone. Our core focus areas in 2023 are continuing to launch innovative borderless products, improving our gross margin and driving efficiencies in operating expenses, culminating in a common goal of consistent cash flow generation. We initiated several measures to pursue greater efficiency and to realign our business and strategic priorities. In the second quarter of 2023, we exited our US CBD operations, which allowed us to reduce costs and focus on adult use and medical cannabis markets.

Today, we announced plans to exit our Winnipeg, Manitoba facility by the end of this year, which we anticipate will drive additional OpEx savings and improvements in COGS in 2024. As we previously announced in 2023, we anticipate saving $20 million to $25 million in operating expenses and we anticipate capturing incremental savings of $10 million to $15 million in 2024 as a result of our announcements today to exit our Winnipeg facility and implement additional operating expense reductions.

While we execute these efficiency focused initiatives, we are laser focused on winning in market. Our Spinach edibles remain the number one ranked edible in Canada as of June. Spinach is the only brand that is top 10 in market share in Canada in all categories it participates in, which includes edible, vapes, pre-rolls and flower. In Israel, Peace Naturals continues to be a top brand driven by our powerful genetics program and cultivation capabilities. And lastly, with the US exit, our teams are working on the relaunch of the Lord Jones brand into adult use categories in Canada with its anticipated introduction in Q4 of this year.

Now I'll dive into each of these elements of our business in more detail. Following our over-achievement in savings in 2022, we increased our operating expense saving target this year to $20 million to $25 million, driven partly by the exit of the US business. The additional cost reductions announced today will have some in year benefit but will primarily hit full year 2024 given the timing of the decisions with anticipated incremental savings of $10 million to $15 million. The continued improvement in free cash flow this quarter proves our hard work in driving OpEx reduction and putting our industry leading balance sheet to work to achieve greater ROI is paying off.

Today, we also announced the planned exit of our Winnipeg, Manitoba facility. We originally purchased this fermentation facility to scale up the development of our highly specialized cultured cannabinoid IP. While we can continue to utilize this IP and rare cannabinoids, we can now do so in an asset light approach. We were the first and still the only company to ferment cannabinoids and commercialize them in Canada. As part of our winning, branded portfolio strategy, we'll continue to focus on developing products, utilizing rare cannabinoids to drive differentiated effects for our consumers. This change is anticipated to drive material COGS and OpEx savings in 2024.

We're also preparing the facility for sale, which is intended to yield additional cash to our already industry leading cash balance. The exit of our US CBD business enables us to focus on adult use products while preserving cash for eventual US entry. We believe that one day the US will be one of the most important cannabis markets in the world. But maintaining a CBD business is no longer part of our plan. Our resources are best spent staying laser focused on the borderless adult-use products that we can sell in legal markets and by driving cost savings and process efficiencies to be cash flow positive.

We know that there's value in the Lord Jones brand, and we're excited to bring Lord Jones back to its adult-use roots by launching new THC focused products in the Canadian adult-use market later this year. Along with a refreshed visual identity for Lord Jones, our ultimate goal is to create a borderless suite of products under this brand. We are excited to share this product portfolio with you in the future, as it will be highly complementary to our Spinach offerings and differentiated from other brands in the market today. James will go into more detail on the financial results during his remarks. But I want to comment on the wins this quarter. We further improved our industry leading balance sheet, increasing our cash and short term investment balance by approximately $5 million from Q1 2023. This achievement was driven by improved gross margin, lower OpEx, robust interest income and improved working capital management.

Gross margins expanded by an impressive 130 basis points sequentially to 16.3%, a big win given the macro driven headwinds on the top line. And our investment strategy continues to pay dividends, resulting in $12.5 million interest income in the second quarter. We intend to build on this momentum in the back half as we realize further P&L efficiencies and additional interest income from our cash and short term investments.

Turning to the business, in Canada during the second quarter, we continued to execute our plan to create a robust offering of borderless products, highlighted by new launches. As of June 2023, Spinach is the number three ranked cannabis brand in Canada. And is currently the only cannabis brand that is top 10 in all categories it participates in, which includes the number one ranking in the edibles category during the second quarter of 2023.

Spinach edibles products accounted for 14.8% of the market in June, remaining the market leader in edibles. We have an incredible product that continues to launch a new flavor profiles in cannabinoid blends. The perfect example of a borderless, scalable product. The edibles category continues to feel the residual impact for the now banned chewable cannabis extracts. As these banned products continue to be removed from the market, we anticipate a recovery in our overall market share and are already seeing an improvement, with weekly retail sales up 15% since June.

This quarter, we launched a new SOURZ by Spinach flavor. Our take on the timeless summer drink Pink Lemonade infused with raspberry and refreshing lemonade flavors. Having just launched in late May, this product has quickly gained market share. Pink Lemonade is already number four in our portfolio and keeps rising. We're excited for adult consumers to try this new flavor this summer. In the vape category, we held a 4.1% market share in June, maintaining a number seven market share position. We will build on that momentum in the back half of 2023 with the continued push to include flavor forward profile and rare cannabinoids in our vapes, driving innovation while leaning on our winning formulations that consumers know and love across portfolio.

In July, we launched three new vapes under the Spinach brand. These new vapes come in a 1.2-gram format and the flavoring offerings of Pink Lemonade, Peach Punch and Strawberry Slurricane. In Q2, we launched several new offerings to bolster the Spanish pre-roll portfolio, including Sonic Lemon Fuel pre-rolls and three new infused pre-roll offerings.

In Q2, we were the number eight brand in market share in pre-rolls, a significant improvement from number 14 in Q4. We expect that with these new launches and additional ones coming down the pike, we can further improve on this position. Our flower performance continues to be propelled by a robust genetics program and best-in-class cultivation capabilities at GrowCo. And as of June 2023, we are the number two flower brand.

We had three SKUs in the top 10 in the second quarter, GMO cookies in 3.5 gram and 28 gram and our Wedding Cake 28 gram. GrowCo's performance in cultivation continues to be strong. GrowCo reported a preliminary unaudited revenue of approximately $3.6 million to non-Cronos customers in the second quarter. Additionally, the credit facility that Cronos previously provided GrowCo currently has $72.4 million outstanding following the principal repayment of $2.5 million by GrowCo in Q2. In addition, GrowCo made a $1.7 million interest payment in Q2. The solid financial performance of GrowCo yielding equity pickup, interest payments and loan payback to Cronos is a vital component of our overall financial picture.

Turning to Israel. In June 2023, the Knesset Health Committee changed the cannabis regulations to make it easier for some patients to obtain prescription; the new regulations scheduled to begin in December 2023. For certain medical conditions, patients will no longer be required to obtain a license with approval from the Health Ministry. Now, doctors can directly prescribe cannabis to those patients. This change simplifies the process for patients and doctors and is expected to increase access and patient count. Shortly after the announcement, I met with regulators, customers and patients, and I'm happy that they share my excitement about the growth potential in the Israeli market and the progress this change should contribute towards realizing that potential.

We've always had confidence in the long-term potential of our position in the Israeli market, as it's still one of the world's largest medical programs. Our Peace Naturals brand launched two new pre-roll products, Wedding Rolls and Cocoa Bomba last quarter. Pre-rolls have become a substantial and growing part of the market in Canada, and we're excited to bring this innovation to the Israeli market, which is still primarily dominated by flower. In addition to the pre-roll launches, we also launched a Space Cake dried flower offering. In collaboration with Fighters for Life, an Israeli organization that works with veterans to acclimate to civilian life after military service, Peace Naturals partnered to launch a fundraising campaign ad that appeared on local TV and social media in Israel. This issue is one that has resonated with our consumers in Israel, and we're proud to support this organization once again.

Moving to Germany, we're excited to announce that we signed a distribution agreement in July with one of the leading distributors of medical cannabis in Germany. We anticipate commencing shipments in the third quarter. Reentering Germany is a significant milestone for Cronos, and we look forward to expanding our reach and brand awareness. The recently proposed regulatory change to reschedule cannabis no longer labeling medical cannabis as a narcotic is expected to unlock significant growth in the market. And we intend to establish our Peace Naturals brand as the top brand similar to our execution in Israel. This quarter's successes and pivots resulted in cost savings and better positioned us to assemble a portfolio of borderless products with strategic infrastructure and global partnerships. The combination of these efforts and industry leading balance sheet set us up well to execute in any market.

With that, I'd like to pass it on to James to take you through our financials.

James Holm

Chief Financial Officer, Cronos Group, Inc.

Thanks, Mike. Good morning, everyone. I will now review our second quarter 2023 results for continuing operations in relation to the prior year period. The company reported consolidated net revenue in the second quarter of $19 million, a 12% decrease from the prior year. Constant currency consolidated net revenue decreased by 6% to $20.2 million. The revenue change was primarily driven by lower cannabis flower sales in Israel due to competitive activity, the slowdown in patient permit authorizations and political unrest. And in Canada due to adverse price mix shift in the cannabis flower category driving increased excise tax payments as a percent of revenue. Consolidated results were additionally impacted by the weakened Canadian dollar and Israeli shekel against the US dollar during the current period.

Consolidated gross profit in the second quarter was $3.1 million, equating to a 16.3% gross margin, representing a $1.2 million decline from the prior year. The decline was primarily due to lower cannabis flower sales in Israel and an adverse price mix shift in cannabis flower sales in Canada. These results were partially offset by lower biomass costs. Our quarterly results in 2022 were volatile quarter to quarter, driven by the realignment of our business, which makes the comparison on the gross margin line difficult. With that in mind, looking at both the full year 2022, we had a positive 17.8% gross margin and the sequential progression from Q4 2022 at 5.7% and Q1 2023 of 15% gross margin to Q2 2023 where we get a positive 16.3% gross margin.

You can see encouraging signs of improvement and stability. And we intend to build off this momentum throughout 2023 and into 2024. Consolidated adjusted EBITDA in the second quarter was negative $15.9 million, representing a $0.7 million improvement from the prior year. The improvement was primarily driven by a decline in general and administrative and research and development expenses. As previously mentioned, we increased our expected cost savings target in 2023 from $10 million to $20 million to a new range of $20 million to $25 million.

As a continuation of this savings program, we anticipate that the exit of the Cronos fermentation facility and the additional operating expense reductions announced today will capture an incremental $10 million to $15 million in the full year savings in 2024.

Turning to the balance sheet, the company ended the quarter with approximately $841 million in cash and short-term investments, which is up approximately $4.5 million from the first quarter. In addition to maximizing the return on our cash, we received an interest payment on our GrowCo senior secured loan of $1.7 million, a principal payment of $2.5 million and $1.3 million of payments on the Mucci promissory note for total cash paid by GrowCo and our JV partners to Cronos of $5.5 million in Q2.

Having the best balance sheet in the cannabis industry enables us to take calculated strategic bets while we remain steadfastly focused on reducing cash burn. Moving to free cash flow defined as operating cash flow less CapEx, Q2 2023 was negative $12.3 million representing a 36% improvement year-over-year. Backing out the income taxes payable associated with the one time Altria warrant relinquishment in Q1, the sequential improvement in free cash flow was 22%. We anticipate recouping most of the tax payment associated with the one time Altria warrant relinquishment over the next three years.

Lastly, moving to outlook and guidance, we anticipate the net change in cash defined as the sum of cash and cash equivalents and short term investment for the remainder of fiscal year 2023 will decline by less than $5 million to $10 million. This is an improvement to the previous guidance of declining less than $25 million in the remaining nine months of fiscal year 2023. The company also still expects the net change in cash will be positive in 2024.

The improved cash flow trajectory will be driven by, among other items, continued gross margin improvement, operating expense reduction efforts and anticipated interest income of $20 million to $25 million for the remainder of fiscal year 2023. While we continue to execute on operating expense reductions and cash flow management, we made the decision this quarter to discontinue providing revenue guidance and to withdraw our previously announced net revenue target of $100 million to $110 million for the full year 2023. The discontinuance of providing net revenue guidance reflects turbulent market conditions beyond previous expectations in the markets we operate in specifically increasing political unrest and stagnant patient growth in Israel.

The decision to exit the US business and competitive activity in Canada driven by the lingering effects of edible extracts. In addition, foreign exchange rates have had an unfavorable impact on our net revenue. Despite the top line headwinds, we have a lot of wins to point to and I share in Mike's confidence in the trajectory of the business and our preparedness for entry into new markets as they become available.

With that, I'll turn it back to Mike.

Michael Ryan Gorenstein

Chairman, President & Chief Executive Officer, Cronos Group, Inc.

Thank you, James. We are winning in Canada and Israel. Thanks to all the hard work from our employees to bring best in class borderless products to market. Our Spinach brand is the only brand that holds a top 10 market share position in all categories it participate in, which are flower, pre-rolls, vapes and edibles. We are confident that as regulations change, we will be among the best positioned cannabis companies to capture additional market share in any market.

Before getting into questions, I want to level set what is under the Cronos umbrella and where things stand today. We closed Q2 with $841 million in cash and equivalents and zero debt, and we generated $12.5 million interest income in Q2 with an anticipation to generate an additional $20 million to $25 million in interest income through the remainder of 2023. Our Spinach brand has the following market share range for June 2023. Overall, Spinach is the number three cannabis brand. Number one in edibles. Number two in flower. Number eight in pre-rolls and quickly taking share. Number seven in vape and also gaining ground.

We have a leading medical brand, Peace Naturals, in Israel, which posted $5.4 million in net revenue in Q2. We have a 6.3% stake in PharmaCann, one of the largest private US MSOs currently on our books for $49 million. We have an approximate 10% stake in Vitura, a leading publicly traded Australian medical cannabis provider worth approximately $18.9 million as of the end of Q2. We own 50% of the equity in Cronos GrowCo, which is profitable and between GrowCo and our JV partner they paid us $5.5 million in principal and interest payments in Q2. We ended the quarter with the remaining balance of approximately $84 million on our combined loans to GrowCo and its partners. We own real estate and multiple licensed facilities free from any encumbrances. And last but certainly not least, we have the exclusive partnership with Altria on a global basis.

At the close of the market yesterday, Cronos traded at a market cap of approximately $720 million, and an enterprise value of approximately negative $120 million. While this quarter's top line fell short of what I believe Cronos is capable of achieving, we ended the quarter with more cash than we had last quarter. If there's one common theme from cannabis earnings call the last few quarters, it's that cash is king and given that we have more than 4 times more net cash than the closest competitor, Cronos wears the crown.

With that, I'll open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Please limit yourself to one question and one follow-up. Please stand by while we compile the Q&A roster. One moment for first question. Our first question comes from the line of Vivien Azer from Cowen. Your line is open.

Vivien Azer
Analyst, TD Cowen

Q

Thank you. Good morning.

Michael Ryan Gorenstein
Chairman, President & Chief Executive Officer, Cronos Group, Inc.

A

Good morning.

Vivien Azer
Analyst, TD Cowen

Q

So, Mike, I was wondering if we could talk a little bit more about the anticipated launch of Lord Jones in Canada in particular, in light of your commentary around, volatility in the Canadian marketplace and just reflecting on the brand's legacy positioning in the US and how you're thinking about positioning it in Canada now, just given the challenges at the most premium end of the market. Thank you.

Michael Ryan Gorenstein
Chairman, President & Chief Executive Officer, Cronos Group, Inc.

A

Sure. Thanks, Vivien. It's a great question. So, we think about Lord Jones. We've always liked its historical position at the premium end, specifically in edibles. I think that we've done a really good job of being able to differentiate, especially in that category. But we do still see that there are spaces, overall in premium products when you're differentiating, flower might be a little more difficult. But we do think that there's an opportunity, given a lot of the work we've done on a completely incremental type of edible product that fits really well with Lord Jones brand to sort of tie those together for a launch.

And I also think when you look overall, the portfolio, if you look at our, where we are sitting with distribution, the strength that we've had with Spinach, being able to leverage the relationships that we have with our trade partners and the knowledge and product development that we've had over the last few years. We do see the opportunity, we think it's incremental. We're generally very careful with what we do decide to launch. So I'm pretty excited about it, obviously. It's when you look at premium, your market size is going to be something where Spinach would be. But we think from a margin and gross profit perspective, it's a really good idea to launch in a better place, to really fine tune the products and trying to have products in the US that don't necessarily fit the future state of what the brand looks like.

Vivien Azer
Analyst, TD Cowen

Q

Sure that makes good sense. And just to follow up on that, from a distribution standpoint, is there kind of any logic to taking a more discreet view of distribution to make sure that you're preserving that brand equity rather than going full national distribution?

Michael Ryan Gorenstein
Chairman, President & Chief Executive Officer, Cronos Group, Inc.

A

It's a great question. I think that a lot of that when you look -- you look at the different provinces, how deep maybe selling would be will depend on what the setup of the stores look like in each given province. Obviously, there are some that, you would expect you would do better on the premium end. But of the major provinces by population, I think it makes sense still to put the same amount of focus. But I think that you'll still see a national launch. But we, as you know, tend to do a more phased rollout and make sure that we've got the demand in the right positioning.

Vivien Azer
Analyst, TD Cowen

Q

Makes sense. Thank you.

Operator: Thank you. [Operator Instructions] One moment for the Q&A to compile. All right, as there are no further questions in the queue. This concludes today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.